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OUTLOOK

FOR THE ECONOMY AND REAL ESTATE

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The Outlook for the Economy and Real Estate

The flash estimate of a 3.2 percent growth rate for fourth quarter Gross National Product (GNP) was due mostly to inventory re-stocking activity by manufacturers, as moderate growth in real final sales signaled the onset of the expected decline in personal consumption expenditures. The government also revised the third quarter growth rate for GNP from 4.3 percent to 3.0 percent indicating considerably slower growth because of falling inventory investment. The fourth quarter flash estimate for GNP is expected to be revised down given the recent slowing in consumer spending coupled with the recent slip in housing starts. GNP growth could slow further to 1.0 percent in the first quarter of 1986 as manufacturers reduce production because of high inventory levels that can not be depleted by financially-strapped consumers. The presently high levels of consumer debt will be pushed even higher during the holiday buying season and should restrict consumer outlays in the new year as consumers attempt to boost personal savings to pay off their debts. Growth in output should rise modestly during the remainder of 1986 averaging 2.0 percent for the year.

The unemployment rate declined slightly in November to 7.0 percent, down from 7.1 percent in October. Civilian employment rose by 60,000 new jobs to almost 108 million in November, but this increase was offset by 92,000 workers who left the workforce. The expected sluggish GNP growth could raise unemployment in 1986 before stabillizing in 1987 as economic growth is renewed.

Prices for food and energy products forced the consumer price index 0.6 percent higher in November and about 3.6 percent above 12 months ago. The November increases in the capacity utilization rate and the industrial production index were due to high levels of consumer spending and inventory investment, and do not mean the return of rapid economic growth and rekindled inflation. Consumer price inflation should fall slightly in 1986 before rising in 1987.

The recent passage of the Gramm-Rudman-Hollings legislation to eliminate deficits by 1991 is a symbol of Congressional concern for high federal deficits. However, after implementation this measure will prove but a modest step towards reducing deficits and artificially high real interest rates that have restrained real economic growth. Slow economic growth should allow long-term interest rates to fall modestly in the first half of 1986, before stabillizing as economic growth returns in 1987. Short-term interest rates should continue on a modest downward trend through 1986, and could drop significantly lower if the Federal Reserve acts quickly to smooth the transition from fiscal to monetary stimulation of the economy that is implied by passage and modest implementation of Gramm-Rudman-Hollings.

Real Estate Markets

The severe winter storms in the Northeast and Midwest are largely responsible for the 12.2 percent drop in November housing starts activity. Housing starts have been erractic since the spring, so a one month decline is not significant. Housing starts should total 1.73 million in 1985 and lower interest rates should raise starts to almost 1.85 million in 1986. Existing single-family home sales, which have recorded healthy gains since August, are expected to average 3.35 million units in 1986, and 3.4 million units in 1987. The median price of an existing single-family home in November retreated to $74,600, from a revised October median price of $74,800. Responding to this housing activity, stores and other commercial construction should total 507 million square feet in 1986. Office building construction should retreat from the near record- breaking pace of 310 million square feet in 1985 to about 250 million square feet in 1986. Industrial building construction should total about 145 million square feet in 1986 as the depreciating U.S. dollar strengthens foreign markets for U.S. goods.

Special Supplement

Economic Impacts of The Gramm-Rudman-Hollings Deficit Reduction Legislation

On December 11, Congress passed and the President signed the Balanced Budget and Emergency Deficit Control Act of 1985, otherwise known as the Gramm-Rudman-Hollings (GRH) proposal. This legislation, sponsored by Senators Gramm (R., Texas), Rudman (R., New Hampshire) and Hollings (D., South Carolina), establishes a path of shrinking deficits starting in FY1986. The mandated deficit targets are as follows: $172 billion in FY1986, $144 billion in FY1987, $108 billion in FY1988, $72 billion in FY1989, $36 billion in FY1990, and a balanced budget in 1991. The Administration is constrained by these deficit limits in formulating the annual budget that is submitted to the Congress. Similarly, Congressional budget resolutions are required to adhere to these targets.

On March 1, 1986 and then on each following September 1, the Congressional Budget Office (CBO) and the Administration's Office of Management and Budget (OMB) are required to prepare estimates of the deficit for the remainder of FY1986 or the following fiscal year, taking into account expected economic conditions and Congressional budget actions as of that date. These estimates are to be submitted to the Comptroller General of the General Accounting Office (GAO) who is to review the estimates and resolve differences. If GAO determines that the projected deficit exceeds the target for the fiscal year by more than $10 billion, the President would be required to make automatic spending reductions to achieve that target if Congress and the President are unable to agree on an alternative plan by October 15. Defense would take half of the automatic spending cuts while domestic programs would take the other half, with Social Security, interest on the debt, and the primary low-income programs exempt. Note that while the automatic feature of the bill calls for spending reductions only, taxes could be increased as part of an alternative plan to achieve the deficit target.

Also included in the bill is a provision for waiving this procedure in the event of a weak economy. If CBO or OMB project two consecutive quarters of negative growth in real or inflation-adjusted Gross National Product (GNP) or if the Department of Commerce reports that real GNP growth during the current quarter and the immediately preceeding quarter is less than 1 percent, the deficit target is waived for the remainder of the current fiscal year and/or the following fiscal year.

Provided the Federal Reserve Board (FED) acts quickly to offset the decline in aggregate demand resulting from the cuts in federal spending with lower interest rates brought on by a more accommodative monetary policy, deficit reduction through spending cuts would have very desirable impacts on overall economic performance. As shown in Table 1, long-term interest rates would likely decline by 2 percentage points within five years. Lower interest rates would have numerous beneficial impacts--increased activity in the interest-sensitive sectors of the economy such as housing and business investment, a reduced value of the dollar which would allow a steady decline in the U.S. trade deficit, and further reductions of the federal deficit by reducing interest payments on the outstanding federal debt. Within five years total employment would increase by over a million jobs. The only negative effect would be an increase of inflation of about one percentage point. This would be due primarily to the reduced value of the dollar which would boost the cost of imported goods and services and diminish price pressure on domestic producers. However, this increase in inflation would subside as the dollar stabilized at its new lower value. Without an accommodative shift in monetary policy, the reduction in federal spending prescribed by GRH would cause weakness in the economy. However, that fact plus continued low inflation should pressure the FED into providing the needed stimulus.

Table 1

Macroeconomic Impacts of the Gramm-Rudman-Hollings
Proposal with Accommodative Monetary Policy
(percent change from baseline)

	1986	1987	1988	1989	1990	1991
Real GNP	0.1	0.6	1.2	1.8	2.1	2.3
Inflation (Percentage Points)	-0.3	0.4	0.5	0.7	0.9	1.0
Employment (Millions of Jobs)	0.0	0.2	0.4	0.7	1.0	1.3
Mortgage Rate (Percentage Points)	-0.7	-1.3	-1.6	-1.8	-2.0	-2.0
Housing Starts (Thousand of Units)	100	225	280	310	320	330
Nonresidential Investment						
Equipment	0.5	2.7	6.2	10.1	13.1	13.5
Structures	0.3	2.1	4.9	8.8	12.8	15.8

Source: NATIONAL ASSOCIATION OF REALTORS®

Unfortunately, these desirable impacts of deficit reduction are unlikely to come about due to the inability to reach a political consensus on the required cuts in spending. The President will likely resist deep cuts in defense spending while House Democrats will likely resist deep cuts in social programs. This leaves two options-either tax increases or GRH will be subverted or repealed through future legislation. At this point it seems reasonable to expect that some deficit reduction will occur in roughly the following proportions-1/3 from defense, 1/3 from social programs, and 1/3 from increased taxes. The tax increases are unlikely to come from across-the-board increases in personal and corporate tax rates. Rather, revenues are likely to be raised through a stiffer individual and corporate minimum tax and through further dilution of investment incentives, such as reduction or repeal of the investment tax credit and lengthening of cost recovery periods for depreciable assets. Unfortunately, such tax increases would to a large extent nullify the positive impacts of lower interest rates on business investment. As a result the economic benefits of deficit reduction with these types of tax increases are significantly less than deficit reduction achieved solely through spending cuts.

Further, even if GRH is not repealed or weakened through future legislation, there are sufficient escape clauses within the bill that the prescribed deficit targets are unlikely to be achieved. Thus, the deficit in FY1987 is more likely to decline to about $175 billion, not $144 billion. While GRH is likely to produce some deficit reduction, it would be a mistake to assume that its passage has put us on a path toward a balanced budget by 1991.